New York Court of Appeals Declines to Expand Outside Advisor Liability

On October 21, 2010, in a 4-3 decision, New York's highest court issued a ruling that preserves and perhaps strengthens a New York bar on claims by company shareholders or creditors against the company's outside advisors (e.g., auditors, lawyers, investment bankers) where the claims arise out of financial fraud perpetrated by company management. In so ruling, the Court of Appeals found that management's wrongful acts were to be "imputed" to the corporation, and the claims were therefore to be barred under New York's common law doctrine of *in pari delicto*, which mandates that courts will not intercede to resolve a dispute between two wrongdoers. The Court of Appeals declined to accept arguments that management's acts should not be imputed to the corporation under New York's "adverse interest" exception to the doctrine of "imputation."

According to the three-judge dissent: "The majority opinion effectively precludes litigation by derivative corporate plaintiffs or litigation trustees to recover against negligent or complicit outside actors—even where the outside actor, hired to perform essential gatekeeping and monitoring functions, actively colludes with corrupt corporate insiders."

I. Background

Three long-standing and interconnected New York legal doctrines animated the Court's analysis: "imputation," the "adverse interest" exception to the doctrine of imputation and "*in pari delicto*."

Imputation. New York's doctrine of "imputation" provides that the acts of corporate agents, such as corporate officers acting within the scope of their authority, are presumptively imputed to the corporation—such that the corporation is considered to have committed the acts itself. Imputation is presumed even where a corporate agent exhibits poor business judgment or commits fraud.

The Adverse Interest Exception to Imputation. New York courts have recognized an exception to the imputation doctrine where the agent's misconduct benefits primarily himself or a third party and thus represents misconduct *against* the corporation rather than on its behalf.

In Pari Delicto. New York's common law doctrine of *in pari delicto*, meaning "equal at fault," provides that courts will not intercede in disputes between wrongdoers. It therefore bars claims for which the plaintiff shares responsibility. The doctrine of *in pari delicto* seeks to address two important public policy concerns: first, it deters illegality by denying judicial relief to admitted wrongdoers. Second, it avoids entangling courts in disputes between wrongdoers.

II. Facts and Procedural History

The Court of Appeals' decision addressed certified questions regarding the application of New York's adverse interest exception and doctrine of *in pari delicto* from two separate cases—*Kirschner v. KPMG LLP* ("*Kirschner*") and *Teachers' Retirement System of Louisiana and City of New Orleans Employees' Retirement System v. PricewaterhouseCoopers LLP* ("*Teachers*")—that came up from the United States Court of Appeals for the Second Circuit and the Supreme Court of Delaware.

Kirschner, filed originally in the Southern District of New York, was precipitated by the collapse and Chapter 11 filing of Refco, Inc., a provider of financial market services, after Refco disclosed that its senior officers had orchestrated a series of loans to fraudulently enhance Refco's financial position. The litigation trustee filed complaints against the auditors, underwriters and law firm involved in Refco's securities offerings for facilitating and/or failing to detect the fraud. The District Court, however, dismissed these claims under New York's *in pari delicto* doctrine, finding that the wrongdoing of Refco's officers was properly imputed to Refco and was not excluded under the adverse interest exception.

In *Teachers*, a derivative action against AIG in the Delaware Court of Chancery, plaintiffs alleged that AIG's outside auditors, PricewaterhouseCoopers LLP, had failed in their auditing responsibilities and therefore failed to detect or report the fraudulent conduct of AIG's senior officers. The Court of Chancery, however, dismissed the plaintiffs' claim, finding that New York's law of agency imputed the wrongful acts of AIG's senior officers to AIG, and accordingly, *in pari delicto* barred a derivative action on behalf of AIG against AIG's auditors.

Both the United States Court of Appeals for the Second Circuit and the Supreme Court of Delaware certified questions on the New York doctrine of *in pari delicto* to the New York Court of Appeals. This is the first occasion on which the New York Court of Appeals accepted a question certified by the highest court of a sister state.

III. Rationale of the Court (Per Read, J.)

In its Opinion, the Court of Appeals reaffirmed the long-standing presumption under New York's agency law that the acts of agents, and the knowledge that agents acquire while acting within the scope of their authority, are presumptively imputed to their principals. The Court justified this imputation in the case of an agent's misconduct as reflecting the recognition that principals, rather than third parties, are best suited to police their chosen agents. If such presumption holds in the case of misconduct by corporate agents, then their acts are imputed to the corporation, thereby barring it from pursuing claims against its outside advisors on account of such misconduct under the doctrine of *in pari delicto*.

The Court emphasized that the adverse interest exception to imputation is of "narrow scope," limited to circumstances where the corporate agent "totally abandoned" the corporation's interests—such as outright theft, looting or embezzlement—for the agent's exclusive benefit. The exception cannot be invoked merely because the agent had a conflict of interest or did not act *primarily* for the corporation's benefit. The Court noted that the interests of corporate insiders are often linked to those of their corporations through stock options and bonuses that are contingent upon the company's performance, which may motivate management to falsely overstate a company's financial performance. This type of self interest, however, does not trigger the adverse interest exception since this conduct defrauds <u>others</u> for the <u>corporation's</u> benefit; the exception only applies to conduct that defrauds the <u>corporation</u> solely for the <u>agent's</u> benefit.

The Court, moreover, affirmed that the adverse interest exception will not consider an agent's personal motive for acting, or whether benefits to the corporation from the agent's actions were only short-term and "illusory," and resulted in long-term harm to the corporation. According to the Court, the adverse interest exception simply determines whether the agent's acts benefited or harmed the corporation at the time that the agent performed them. The Court noted that allowing a corporation to avoid the consequences of corporate acts simply because an employee performed them with his or her own personal profit in mind would "explode" the adverse interest exception, turning the exception "into a nearly impermeable rule barring imputation in every case."

The Court considered but rejected the approaches of the New Jersey and Pennsylvania Supreme Courts to the doctrines of imputation and *in pari delicto*. Both states have fashioned carve-outs from traditional agency law in cases of corporate fraud so as to lift the *in pari delicto* bar to claims against negligent outside auditors (New Jersey) and collusive outside professionals (Pennsylvania). The Court questioned the fairness of these carve-outs, noting that they "may be viewed as creating a double standard whereby the innocent stakeholders of the corporation's outside professionals are held responsible for the sins of their errant agents while the innocent stakeholders of the corporation itself are not charged with knowledge of their wrongdoing agents."

The Court also considered but rejected adopting a comparative negligence approach to *in pari delicto* cases, whereby the doctrine would "not be a total bar to recovery, but at most a basis for apportionment of fault and damages as between the defendant and the company's successor trustee." The Court noted that this would contradict "the public policy purposes at the heart of *in pari delicto* – deterrence and the unseemliness of the judiciary serving as paymaster of the wages of crime."

The Court concluded that altering New York precedent would not, in fact, produce a meaningful additional deterrent to professional misconduct or malpractice, and that the "speculative public policy benefits" associated with reformulating New York law were outweighed by the "important public policies that undergird our precedents in this area" and the importance of maintaining legal stability and certainty.

IV. The Dissent (Per Ciparick, J.)

The Court of Appeals' dissent expressed support for carve-outs or exceptions to the *in pari delicto* and imputation doctrines for complicit or negligent outside gatekeeper professionals who enable corporate insider fraud, similar to those adopted by the New Jersey and Pennsylvania courts. It argued that such an approach would maximize diligence and thwart malfeasance by auditors and other gatekeepers providing critical information to the investing public. The dissent criticized the majority's "rigid" application of the *in pari delicto* and imputation doctrines and the adverse interest exception to imputation as "effectively preclud[ing]" actions against negligent or complicit outside professionals by derivative corporate plaintiffs or litigation trustees. It argued that *in pari delicto*'s rationale of fair dealing and justice suggest, to the contrary, that the doctrine "is *not* a rigid concept, incapable of shaping itself to the particulars of an individual case." Moreover, the dissent argued that the majority's almost automatic imputation presumption—as opposed to a "case-by-case" approach which considered an agent's motive for acting and whether benefits the agents' acts conferred upon the corporation were only short-term and "illusory"—was too sweeping and would "invite gatekeeper professionals to neglect their duty to ferret out fraud by corporate insiders because even if they are negligent, there will be no damages assessed against them for their malfeasance."

V. Conclusion

The New York Court of Appeals has preserved the doctrine of *in pari delicto* and what is often the most viable defense of outside professionals faced with claims by or on behalf of insolvent corporate clients for damages resulting from fraud or other misconduct of former management.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com.